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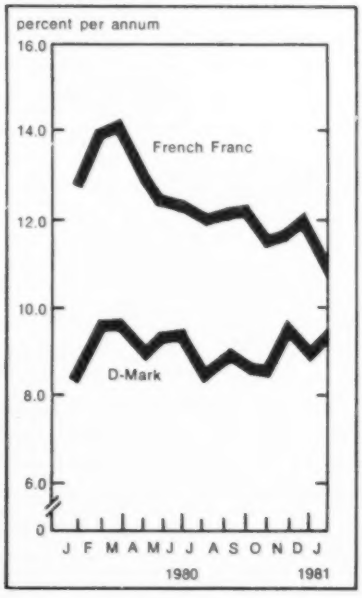
German Monetary Policy at a Crossroads

When the European joint currency arrangement known as the "snake" was enlarged to include France and Italy, most observers expected that the major problem of the new European Monetary System (EMS) would be the strength of the German mark. Since Germany was the member with the lowest inflation rate, it was thought the mark would rise to the top of the EMS currency band and force the other member countries either to adopt tough monetary and interest-rate policies or to devalue their currencies.

The opposite has happened. The German mark has spent most of the last year in the bottom half of the EMS—often the weakest member currency. Germany's low inflation rate was also associated with the lowest interest rates in Europe. And the foreign-exchange markets, when faced with virtually fixed exchange rates, chose the obviously more profitable course of shifting some funds from marks into French francs, guilders, lire, etc., where interest rates were much higher.

Eurocurrency deposit rates
(3-month, asked, end-of-month)



One of the most important lessons of the Bretton Woods system was that individual nations agreeing to fix their currencies to another lose a large measure of control over domestic monetary policy. This is the position that Germany now finds itself in, as its policymakers are being asked to accept the "average" monetary policy of all EMS members. But if Germany acquiesces to the policies of its high-inflation partners, it is placed on a path of slowly-but-surely rising inflation. To the foreign-exchange markets, this means rising interest rates in Germany and capital losses on bonds—a clear reason to move capital into other EMS currencies.

With the United States now on a relatively tight policy course, the strength of the dollar comes into sharp contrast with the "looser" policies of the EMS. Thus, the mark, as well as all EMS currencies, has depreciated sharply against the dollar. And the mark has been extremely weak against its EMS partners.

To arrest the current weakness of the DM, the Bundesbank would have to adopt a more stringent interest-rate policy. But this might threaten EMS stability and would also weaken an economy already in a recession. Thus, the Bundesbank finds itself between a rock and hard place. This does not, however, preclude the need for a decisive policy stance; if nothing is done, Germany could see a 10% inflation rate in a few years. Or it could take harsh steps now, forcing the EMS into a tighter policy stance.

U.K. growth to continue weak, in interest of fighting inflation.

The U.K. economy is now in deep recession, with latest data showing industrial output down 11.5% from a year ago and unemployment at a record 9.3%. This has led to considerable pressure on the government for an expansionary 1981 budget, the details of which are due to be announced March 10. Mrs. Thatcher, however, has reiterated her intention of maintaining current policies until inflation is under control. (Retail prices are still 15% higher than a year ago and the M-3 money supply is up almost 20%.) Most observers are expecting a broadly neutral budget that provides little or no stimulus to growth. Thus, 1981 is likely to witness a continuation of depressed economic conditions, with U.K. output falling further at least until midyear. Some solace can be gained from the gradual deceleration of inflation and monetary growth expected this year and from the reduced interest rates that will probably follow in their path.

Swiss interest rates raised to bolster the franc.

The Swiss monetary authorities demonstrated their resolve to support the franc in the fight against inflation by raising the central bank discount rate from 3.0% to 3.5% on February 3. At the same time, the Lombard rate was increased from 4.0% to 4.5%. Recent franc weakness has contributed to the pickup in inflation. The index of wholesale prices climbed at an annual rate of 8.2% in the fourth quarter of 1980, and higher mortgage rates and labor costs promise a further boost to prices. Swiss interest rates are expected to remain firm as long as the U.S. dollar continues to gain support from high U.S. interest rates, but the franc is expected to benefit most from any downward move in U.S. rates that might occur this year. The Swiss central bank will act to prevent any significant appreciation of the franc against the German mark. This implies scope for an eventual fall in Swiss interest rates that will outstrip any decline in German rates.

Irish economy buffetted by severe recession and high inflation.

An annualized current-account deficit of $1.4 billion and currency weakness have contributed to the severe recession and high inflation now gripping the Irish economy. Against this background, the government announced the details of its new budget on January 28. Official sources describe the budget as deflationary, but its impact is likely to be broadly neutral if not slightly expansionary. Income taxes have been reduced, but sales taxes have been raised, which will boost retail prices and heighten inflationary pressure. The government has announced its intention of reducing the budget deficit from 14.5% of GDP last year to about 13% this year, but most observers fear the deficit could reach 16% of GDP, thereby fueling inflation and widening the balance-of-payments gap. It appears as though Ireland will have to put up with severe recession coupled with a projected average inflation rate of 16% in 1981 (down slightly from 18.2% in 1980), at least until economic growth among its trading partners revives and eases the balance-of-payments constraint.

Tunisia's external-account position deteriorated last year.

Tunisia's overall balance of payments rebounded strongly in 1979, but the improvement appears to have reversed itself in 1980. The current-account deficit narrowed to $300 million in 1979. Merchandise imports advanced 38%, but merchandise exports—mostly of oil—soared 69% and services and transfers receipts jumped 47%. The current-account shortfall was more than covered by long-term capital inflows, and Tunisia recorded an overall payments-balance surplus of $141 million, with a comparable increase in foreign-exchange reserves. External-account data for 1980 have not been published yet, but a rise in reserves of only $11 million to $590 million suggests that the payments surplus narrowed last year. The main reason is a trade deficit for the first three quarters of the year that totaled $970 million—21% higher than the year-earlier period. The deterioration reflected continued fast growth in imports of food, development goods, and oil products coupled with slower growth of merchandise exports. Despite stronger phosphate exports in 1980, certain farm exports fell. And oil export revenues expanded more slowly

as output declined by 5% from 1979 while domestic consumption of oil products continued climbing.

Brazil aims to curb economic growth to ease inflationary pressure.

The Brazilian economy registered a real economic growth rate of 8.5% last year, which permitted maintenance of high levels of employment and social and economic welfare. The increased current expenditures that sustained the rapid pace of growth in 1980, however, collided with economic capacity utilization that neared its limits in several sectors, resulting in an acceleration in the rate of inflation to a record 110%. In an effort to reconcile growth and employment objectives with inflation-control, the authorities intend to slow the rate of real economic growth to about 5% this year. A strategy that permits faster growth in sectors with excess capacity, as in agriculture and exports, and lower growth in sectors with high capacity utilization will be pursued. The government hopes that this will permit a gradual decline in the rate of inflation—although no specific targets have been set.

Domestic energy prices boosted in Thailand.

The Thai government, under strong urging by the World Bank, raised domestic energy prices last month. Price rises implemented by the previous administration in February 1980 ultimately led to its downfall, and one of the first official acts of the present government was to roll back some of those increases—especially for kerosene and diesel fuel. The January 1981 price rises—an average of 16%-17%—are still a minimal response to the problem of underpriced energy. Although the price of diesel fuel is now back up to the level proposed by the previous administration, kerosene prices are still below where they were last year. The new schedule boosts average domestic prices some 52% above where they stood in July 1979. But they are still lagging, as average crude prices have risen well over 100% in the same period. The latest price initiative has apparently not precipitated much political opposition, so that further action on the energy pricing front is likely before yearend.

Expenditure cuts needed to avoid repeat of huge budget gap in Sri Lanka.

The government of Sri Lanka last year recorded an overall budget deficit of 15 billion rupees (about $908 million), 22.7% of GDP. This figure exceeded by more than 68% the deficit originally projected. Supplementary expenditures stemmed from financing large food stocks and, on the capital budget, from cost escalations and from official departments exceeding their budgeted ceilings. The increase in the deficit was financed by additional bank borrowing, and the resultant surge in domestic credit triggered an acceleration of inflation, depreciation of the exchange rate, and an outflow of international reserves. To bring the budget under control, the authorities have cut 25% from the 1981 pre-budget estimates of capital expenditure. No supplementary expenditures are to be allowed, and the overall deficit of 11.8 billion rupees is to be financed externally and through non-inflationary domestic borrowing. Costs are still being underestimated, however, and new projects proposed. Thus, unless the government makes offsetting cuts, expenditures in excess of the amount budgeted will occur once again.

Aluminum prices look set to decline sharply this year.

Aluminum prices are likely to fall over the course of 1981, largely because of a buildup in inventories in 1980 and further accumulation anticipated for this year. Although 1981 aluminum production is expected to decline to 12,386,000 metric tons—down 2% from last year after 5% growth in 1980—demand will remain sluggish. The projected weakness in consumption is based on the expectation of flat economic growth in the United States, Europe, and Japan for much of 1981. Indeed, non-socialist world primary demand is expected to grow by less than 1% after having declined by approximately 5% last year. As a result, inventories are estimated to rise to 2,273,000 metric tons this year—equivalent to 2.26 months of consumption, compared with 1.44 months' supply in 1979. The large overhang is likely to put substantial downward pressure on prices, which are expected to experience double-digit declines this year.

The Debate Over Unemployment Benefits

President Reagan's national economic agenda, according to advance billing, will be a program designed to "restore productivity growth, cut inflation, and put Americans back to work." The precise strategy the president plans to propose for putting as many as possible of the 7.8 million unemployed back on the job is not yet clear. The specifics of his policy prescription will not be revealed until later in the week. But several elements of the government's program of alleviating unemployment—such as the Trade Assistance Act—are reported to be prime targets on the Reagan list of items that may be singled out for spending cuts. These cuts, if proposed, would undoubtedly be highly controversial. Yet there is some evidence to suggest they could lead to lower unemployment by increasing the incentive of unemployed workers to find jobs.

Recent economic and employment data, along with the gloomy outlook for 1981, suggest that the official unemployment rate will probably remain high, ensuring tough resistance to any Reagan initiatives. Despite the surprisingly vigorous economy in the second half of 1980, the unemployment rate during the past nine months has fluctuated within a narrow range of 7.4%-7.8% of the civilian labor force, settling at 7.4% in both December and January. Given the prospect of a sluggish economy or even a renewed downturn in 1981, there is little hope that the unemployment rate will move substantially lower any time soon.

Forecasters have mixed views over the future direction of unemployment. If it remains close to current levels, such cyclical behavior would conform to the pattern set by previous business cycles, with the trough in the unemployment rate being higher in successive cycles. On the other hand, other employment statistics indicate that a gradual strengthening has been taking place in the labor markets since July. Employment as measured by the survey of employer payrolls has now risen six straight months in a row; in January it stood at 91.5 million workers. The average factory workweek has also registered six consecutive monthly advances; at 40.4 hours it is now at is highest level since March of 1979. And overtime in the manufacturing sector is now back to pre-recession levels. The layoff rate also has shown consistent improvement since June, although it is still well above year-ago levels. The continued high unemployment rate in the face of these improvements raises the question of whether it is wise to cut unemployment benefits at this time.

There are many positive things that can be said for providing workers with some financial insulation from the hardships of unemployment—with the returns accruing not only to workers and their families, but also to society as a whole. Unemployment benefits are designed to help minimize economic and emotional dislocation for workers out of a job. It can be argued that the entire economy benefits from a system of unemployment insurance, in that unemployed workers feel less pressure to accept jobs that are below their level of skills. Thus, the argument goes, better use is made of the nation's stock of human capital.

There is concern, however, that not enough attention has been given to the costs associated with the present system of unemployment benefits. The extensive public and private system of compensation for the unemployed has long been identified as a rigidity that inhibits both job search and risk-taking. Further, opponents contend, the programs have now gone far beyond their originally intended purpose of providing worker security against cyclical fluctuations in the economy. They have become an extreme drag on labor market mobility and on the national budget as well. Federal outlays for unemployment compensation in fiscal 1980 totaled $19.5 billion, and a 44% increase in that figure is expected in fiscal 1981.

Unemployed workers today may be eligible for up to 39 weeks of unemployment compensation from the government. Additional benefits are available if it is determined that their job loss was due to foreign competition. Moreover, some firms or unions provide supplemental unemployment benefits. This situation contrasts with that of 1948, when the maximum duration of government benefits was 16-20 weeks, at much lower payment levels.

Empirical research indicates that both a higher level and longer availability of benefits tend to increase the duration of unemployment, probably because they lower the costs to unemployed workers of extending their job-search time. Thus, part of the explanation of why the unemployment rate has hovered near 7.5% for so long in the current business cycle probably lies in the nation's system of unemployment compensation. With such a generous level of benefits, many workers may have postponed looking for another job long after it became obvious that their job loss was permanent rather than temporary. Others may have turned down offers of jobs that were not everything they might have hoped for. And still others may have remained in the labor force—and counted as unemployed—only to continue their eligibility to receive unemployment compensation.

With the Reagan administration now in office, it is likely that the mood in Washington toward providing workers with liberal unemployment insurance benefits has changed. There is already talk of plans to propose a tightening of unemployment compensation eligibility requirements. And the current program of providing 13 weeks of extended benefits when unemployment rises above a specified target level may not survive the budget axe. President Reagan himself has stressed that the emphasis now in policymaking will be toward "rewarding hard work and risk taking" by forcing the government to live within its means.

Diana Bailey

Asia and Oceania — Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes				exchange rate in U.S. dollars	change from year earlier		
		6 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	February 10, 1981		current monetary conditions	
Asia	**Bangladesh**	Aug.	+ 5%	13.7	$ 160	Dec.	300	— 22%	1.4	269	IMF Extended Fund Facility of 800 million SDRs approved for 1981-83.	Oct.	+10%	Aug.	+15%	.0650	— 1%	Tighter monetary policy likely.	**Bangladesh**
Asia	**China, People's Republic**	Dec.	+ 20%	517.0	510	June	3,305	— 7%	2.1	277	Coal exports to expand while petroleum development continues.	n.a.	—	—	—	.6250	—11%	Central control over foreign exchange and budget increases.	**China, People's Republic**
Asia	**Hong Kong**	Oct.	+ 28%	17.6	3,320	n.a.	—	—	—	—	Trade deficit in 1980 estimated at $2.5 billion.	Oct.	+14%	Oct.	+30%	.1890	— 8%	Loan demand buoyed by property and equity boom.	**Hong Kong**
Asia	**India**	Sept.	— 19%	126.3	194	Sept.	7,629	0	6.6	339	Costlier oil imports could push trade deficit to near $6 billion.	Sept	+11%	June	+ 4%	.1230	— 2%	Foreign borrowing rises to finance current-account gap.	**India**
Asia	**Indonesia**	May	+ 61%	46.9	316	Dec.	5,392	+ 33%	7.3	0	Despite rising reserves, borrowing in international markets continues.	Dec.	+17%	Aug.	+47%	.001605	+ 1%	Exchange rate with dollar remains stable at 625.	**Indonesia**
Asia	**Japan**	Sept.	+ 29%	1,015	8,760	Dec.	24,636	+ 26%	2.1	0	Current-account deficit expected to narrow sharply in first half.	Nov.	+ 8%	Oct.	— 2%	.004908	+20%	Prices to moderate and credit to ease slightly.	**Japan**
Asia	**Korea**	Oct.	+ 14%	60.2	1,601	Nov.	3,297	+ 12%	1.8	683	Exports rising, with export letter-of-credit arrivals up strongly.	Nov.	+33%	Oct.	+15%	.001525	—11%	Exchange-rate depreciation slows after sharp decline.	**Korea**
Asia	**Malaysia**	Aug.	+ 20%	19.4	1,458	Oct.	4,666	+ 18%	5.3	0	Exchange rate weakened by higher external interest rates.	Nov.	+10%	Oct.	+14%	.4464	— 3%	Inflationary pressure to continue strong in 1981.	**Malaysia**
Asia	**Nepal**	Sept.	— 29%	1.7*	128	Dec.	190	+ 16%	6.2	24	Oil-induced trade deficit widens; earnings from tourism falter.	Oct.	+18%	July	+13%	.0870	+ 4%	Inflation rate of 25% spurs credit restrictiveness.	**Nepal**
Asia	**Pakistan**	Oct.	+ 7%	23.0	288	Dec.	496	+133%	1.0	382	Imports of inputs liberalized to spur production and exports.	Oct.	+12%	Oct.	+21%	.1020	+ 1%	Reduced deficit financing will cut credit growth.	**Pakistan**
Asia	**Philippines**	Aug.	+ 26%	29.8	625	Dec.	2,846	+ 26%	4.0	853	World recession and weak prices for commodities point to export problems.	Oct.	+14%	Sept.	+20%	.1355	+ 1%	Interest rate ceilings may be lifted.	**Philippines**
Asia	**Singapore**	Oct.	+ 35%	8.9	3,790	Sept.	6,462	+ 13%	3.1	0	Exchange rate buoyed by speculative capital inflow.	Nov.	+ 7%	Sept.	+16%	.4819	+ 4%	Money supply inflated by rising financial investments.	**Singapore**
Asia	**Sri Lanka**	Aug.	+ 4%	3.3	226	Aug.	325	— 28%	2.4	269	High investment shows up in large current-account gap.	Oct.	+23%	Sept.	+15%	.0570	—10%	Credit growth to slow with reduced deficit financing.	**Sri Lanka**
Asia	**Taiwan**	Nov.	+ 19%	32.2	1,716	n.a.	—	—	—	—	Despite recession in major export markets, trade account remains in balance.	Nov.	+23%	Oct.	+21%	.0290	0	Bank competition and investor confidence boost loan growth.	**Taiwan**
Asia	**Thailand**	Oct.	+ 16%	27.3	591	Dec.	1,560	— 15%	2.1	182	High oil prices and strong demand for imports widen trade gap.	Oct.	+17%	June	+15%	.0505	+ 3%	Interest rates expected to remain high.	**Thailand**
Oceania	**Australia**	Dec.	+ 10%	119.1	8,258	Dec.	1,690	+ 19%	0.9	79	Trade surplus expected, despite sluggish export performance.	Sept.	+10%	Nov.	+17%	1.1660	+ 6%	Tight credit policy directed at price stabilization.	**Australia**
Oceania	**New Zealand**	Oct.	+ 15%	20.7	6,591	Nov.	423	— 30%	0.9	169	Increased imports and flat exports widen current-account deficit slightly.	Sept.	+16%	Oct.	+ 1%	.9450	— 4%	Credit conditions restrictive to reduce 15% inflation rate.	**New Zealand**
Oceania	**Fiji**	Oct.	+ 29%	1.1	1,797	Dec.	168	+ 24%	1.1	0	Strong sugar earnings boosted exports and reserves last year.	Dec.	+15%	Nov.	— 2%	1.2525	+ 5%	Oil price rises push inflation rate near 20%.	**Fiji**

*1978

World Interest Rates

market rates of Feb. 10, 1981; bond yields as of Feb. 6, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty-large banks 16.00	17.11	14.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.00	3.50	7.25
Day-to-Day Money	16.625 Feb. 11	17.50	14.50	9.55	10.8125	9.25	17.50	9.00	4.25	8.6875
Treasury Bills 91-day, Middle Rates	15.46	16.95	13.3125	12.50	12.72 one-year	n. a.	15.549 78-day	no dealing	no market	5.875 2-month
Commercial Paper prime, 3-month, asked	15.50 finance paper	17.50 finance paper 15% tax w/h	12.184	11.50 Certified	15.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	15.80	17.50 15% tax w/h	12.625	11.80 Certified	not traded	9.90	n. a.	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	12.74	13.30	13.62	11.425 20% tax w/h	14.03	9.55	16.41	10.79	4.85	8.27
Industrial Bonds prime, long-term, new and old issues, average yield	13.45 Aa Industrials	14.00	14.20	14.915	14.92	9.75	16.64	11.63	5.975	7.03
Bank Short-Term Rate to Best Borrowers (prime rate)	19.50	18.25	15.00	15.50	13.85	11.50	21.00 ⅛ quar'ly fee on outstdng.	11.00	6.00	7.50
Bank Time Deposits 3-month	16.25 Cert. of Dep.	16.70	13.3125	12.35	11.6875	9.65	10.75	9.625 large deposits	6.625 residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	17.125	no market	13.375	no market	11.00	10.125	no market	9.625	6.6875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8354	2.3420	.02907	.2023	.4668	.000986	.4301	.5141	.004910
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.333 *D*	3.875 *P*	4.125 *P*	6.25 *P*	6.75 *P*	1.00 *D*	7.00 *P*	9.875 *P*	8.125 *P*

Eurodollar Deposits
(London, interbank, bid)

Feb. 11

7-day	15.125
1-month	17.125
3-month	17.0625
6-month	17.00

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.54
U.S.-Canada Treasury Bills	−0.23
U.S.-Canada Finance Co. Paper	−1.43
Eurodollars-U.K. Local Auth. Deposits	+0.0625

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	13.50
Over 7 yrs.	13.75
DM Bonds	
7 yrs. and under	9.625
Over 7 yrs.	9.875

Gold Price

London afternoon fixing

519.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Non-Oil-Exporting LDCs: External Sector Developments (1971-80)

(billion dollars, end of period)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Current Account Deficit[1]	11.4	10.8	11.5	36.9	45.9	32.9	28.6	35.8	52.9	68.0
Increase in Official Reserves[1]	1.3	6.4	9.7	2.1	−2.0	12.8	12.0	18.0	11.6	8.8
External Debt Outstanding										
World Bank:	54.2	62.1	75.9	94.8	114.9	139.0	172.0	211.6	246.4	279.5
Augmented:[2]	72.0	81.0	95.0	115.6	154.9	194.4	219.8	273.4	295.8	380.0

[1] IMF

[2] World Bank and B.I.S. data.

Short-Run Adjustment to Deficits by LDCs

The post-1973 period has been marked by major disturbances in the balance of payments of the non-oil-exporting less-developed countries (LDCs). The aggregate current-account deficit of these countries rose from approximately $12 billion in 1973 to about $68 billion in 1980 (see table on bottom of page six). And it is estimated that the combined deficit of the non-oil-exporting LDCs will approach $85 billion by the end of this year. This alarming increase has renewed concerns about economic stagnation and about possible threats to the stability of the international financial system. The manner in which these countries respond to their expanding deficits thus has important implications for the international economy.

Adjustment by the non-oil-exporting LDCs to current-account deficits occurs in both the short and long run. In the short run, such countries have attempted to cut back imports, draw down reserves, or borrow abroad; they have usually utilized a combination of these options. Over a slightly longer period, the non-oil-exporting LDCs have sought to spur exports.

Short-run adjustment to deficits by the non-oil-exporting LDCs has received little attention by international economists, but the issue has become critical to the growing LDC debt problem. Since 1973, the major manifestation of short-term adjustment has been the rapid accumulation of external liabilities by the non-oil-exporting LDCs. External debt totaled an estimated $380 billion at the end of 1980, compared with just $95 billion at the end of 1973. And with the massive OPEC recycling process having been handled within the commercial banking system, an increasing portion of this debt is owed to private lenders.

The developments that have contributed to the recent deterioration in the external accounts of the non-oil-exporting LDCs include huge oil price rises, export stagnation owing to worldwide inflation, and domestic supply disruptions (caused by poor weather, political strife, or port and border closures). Following the initial "recognition lag"—the time it takes to recognize the problem and formulate a short-run adjustment policy--the ultimate course of action by the LDCs is determined by the costs and benefits of each policy.

The import-squeeze option

The degree to which non-oil-exporting LDCs can cut imports to reduce their deficits depends on the "compressibility" of imports, which in turn depends on their composition. In this connection, the proportion of maintenance items (raw materials and intermediate goods) to total imports, the ratio of imports that are competitive with domestic products to those that are not; and the share of (rather squeeze-resistant) government imports in total imports are significant determinants. Interestingly, the ratio of imports to GNP—the degree of trade-dependence—is not necessarily a reliable indicator of the ease or difficulty of import reduction as an adjustment response. A low ratio often implies that all but the most essential imports have already been eliminated, so that any further restriction results in very high costs to the economy. The import-squeeze response is also problematic in that restraints on the import of essential goods, in most countries, have had serious social and political repercussions. Furthermore, the proportion of government revenues that is derived from import taxes is an important element in explaining resistance to import-reduction policies.

Reserve drawdown and foreign borrowing

The drawdown of international reserves is another short-term choice of the deficit-ridden non-oil-exporting LDCs. The rate of increase in their official reserves stepped up dramatically after 1975—nurtured by the easy availability of cheap credit. The reserve accumulation cushioned the impact of the sharp oil price rise of mid-1979, allowing the authorities in the non-oil-exporting LDCs to avoid the use of debilitating import-squeeze policies.

The third short-run response of the non-oil-exporting LDCs to current-account deficits has been external borrowing. And an important determinant of the use of this option is the cost of external finance. Favorable loan terms are not always sufficient to induce foreign borrowing, however, if the external finance is tied to specific procurement. This is because previous debt-servicing requirements preempt large portions of untied external finance, and any subsequent tied finance limits the LDCs' flexibility. In general, high levels of external debt are associated with low levels of future debt—as commercial lenders are more wary of repayment by overborrowed debtors. This, or course, implies greater reliance on import squeezing in periods of low levels of foreign exchange. An interesting phenomenon in this connection is the sometimes perverse impact of high levels of existing debt in an LDC. A heavy debt burden sometimes ensures continued access to credit at favorable terms, especially from commercial lenders seeking to avert default on past loans.

The early 1980s will likely witness modification of the short-term adjustment strategies of the non-oil-exporting LDCs. The upper limits to external financial sources are being reached, while reserve stockpiles are gradually being eroded. This suggests that the non-oil-exporting LDCs will be forced to cut imports—and real economic growth plans—to avoid serious external-account deterioration in the short run.

Deepak Bhattasali

Balanced Growth a Goal for Nigeria

The Nigerian economy has ridden the crest of steep price rises for its chief "crop"—oil—and its balance of payments has improved accordingly. In deficit by some $3.8 billion as recently as 1978, Nigeria's current account shifted into surplus by $1.2 billion in 1979; and that surplus appears to have expanded to $3.0 billion in 1980. Export earnings last year—over 95% of which came from oil—totaled approximately $25½ billion, up 52% from 1979. Import costs are estimated to have risen by 50% to $17.8 billion, owing to an easing of import controls.

The remarkable balance-of-payments improvement is the result of huge price increases for Nigerian oil; price rises averaged 50% in 1979 and 71% last year. Average annual oil output, however, has remained relatively stable. Indeed, oil production last year actually declined slightly—to 2.0 million barrels per day from 2.3 million barrels daily in 1979.

Although overall real GDP growth was about 8% last year, the 1980 economic showing apart from the oil sector was disappointing. Manufacturing output remained stagnant because of a scarcity of raw materials and spare parts. And the agricultural sector, which employs 70% of the population, failed to boost output and continues to fall short of meeting domestic food needs. Food imports in 1980 are estimated to have cost Nigeria over $2 billion, more than 13% of total import costs.

The shortfall in domestic output of food and the heavy imports have also aggravated inflation, estimated at 15% in 1980. Also, the civilian government of President Shagari last April eliminated the wage freeze of the previous military government and replaced it with a system of free collective bargaining, in which guidelines link pay increases to rises in productivity. But the lack of adequate statistical data has made the system unworkable, with the likelihood that wage increases will exceed productivity gains.

The outlook to 1983

The near-term outlook is for annual real GDP growth to continue in the 7%-8% range, with the rate of inflation likely to accelerate, owing to shortages of food, housing, and household goods. And imbalances in the economy will persist. The oil sector—accounting for about 30% of GDP—will continue to dominate, with agricultural and industrial development unlikely to advance significantly.

The government has acknowledged the importance of agricultural development to Nigeria's long-term economic and political future. An important goal of its four-year (1981-85) $151-billion development plan is self-sufficiency in food, but the chances of significant improvement in the near term are poor largely because of agriculture's limited capacity to absorb investment. Similarly, major efforts to promote industry have so far met with only limited success. Structural barriers include insufficient investment in basic industries, inadequate support for existing industries, and a lack of industrial planning coordination. Sustained efforts to spur manufacturing activity should, however, lead to a moderate increase in this sector's current 8.7% share of GDP over the plan period.

Oil to remain paramount

Oil production will thus remain the lynchpin of economic growth in the near term. Output, however, is unlikely to rise much above 2.2 million barrels per day in the next two years, with domestic consumption expected to increase about 12% per year. Thus, whatever higher oil revenues materialize will result from price rises. But with world oil demand likely to be soft because of weakness in the industrialized nations and the probability of rapidly rising imports, Nigeria's large current-account surplus should narrow markedly this year and could swing into deficit as early as 1982.

There are, however, no signs of any foreign-exchange shortage emerging, as Nigeria's international-reserve cushion is well-padded. Reserves (minus gold) totaled $10.1 billion as of end-November 1980, equivalent to 5.5 months of imports. Moreover, Nigeria is considered to be underborrowed in international financial markets. The World Bank places end-1979 external debt at $5.7 billion (with $3.7 disbursed). Debt service payments of $560 million in 1980 represent only 2.1% of foreign-exchange earnings.

In sum, while oil output is critical to economic growth, Nigeria must overcome serious obstacles to the development of viable agricultural and industrial sectors. However, its huge financial and oil reserves (known oil reserves are estimated at 25 billion barrels) and its awareness of the importance of economic diversification afford Nigeria the opportunity to achieve broad-based economic development.

Wally V. Koch

Key External Indicators
(billion dollars, end of period)

	1977	1978	1979	1980 est.	1981	1982 projected	1983
Trade Balance	2.7	0.9	4.9	7.7	6.0	5.0	1.5
Current-Acct. Balance	−1.0	−3.8	1.2	3.0	0.5	−1.0	−3.2
International Reserves	4.2	1.9	5.5	10.1	12.3	13.0	12.0